No. 15073

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

DESSER, RAU & HOFFMAN and JACK L. RAU, Individually,

Appellants,

vs.

GEORGE T. GOGGIN, Trustee in Bankruptcy of Stockholders Publishing Company, Inc., a bankrupt,

Appellee.

Appeal From the United States District Court for the Southern District of California, Central Division.

REPLY BRIEF FOR APPELLANTS.

DESSER & HOFFMAN,
DAVID R. NISALL,
JACK L. RAU,
444 North Camden Drive,
Beverly Hills, California,
Attorneys for Appellants.

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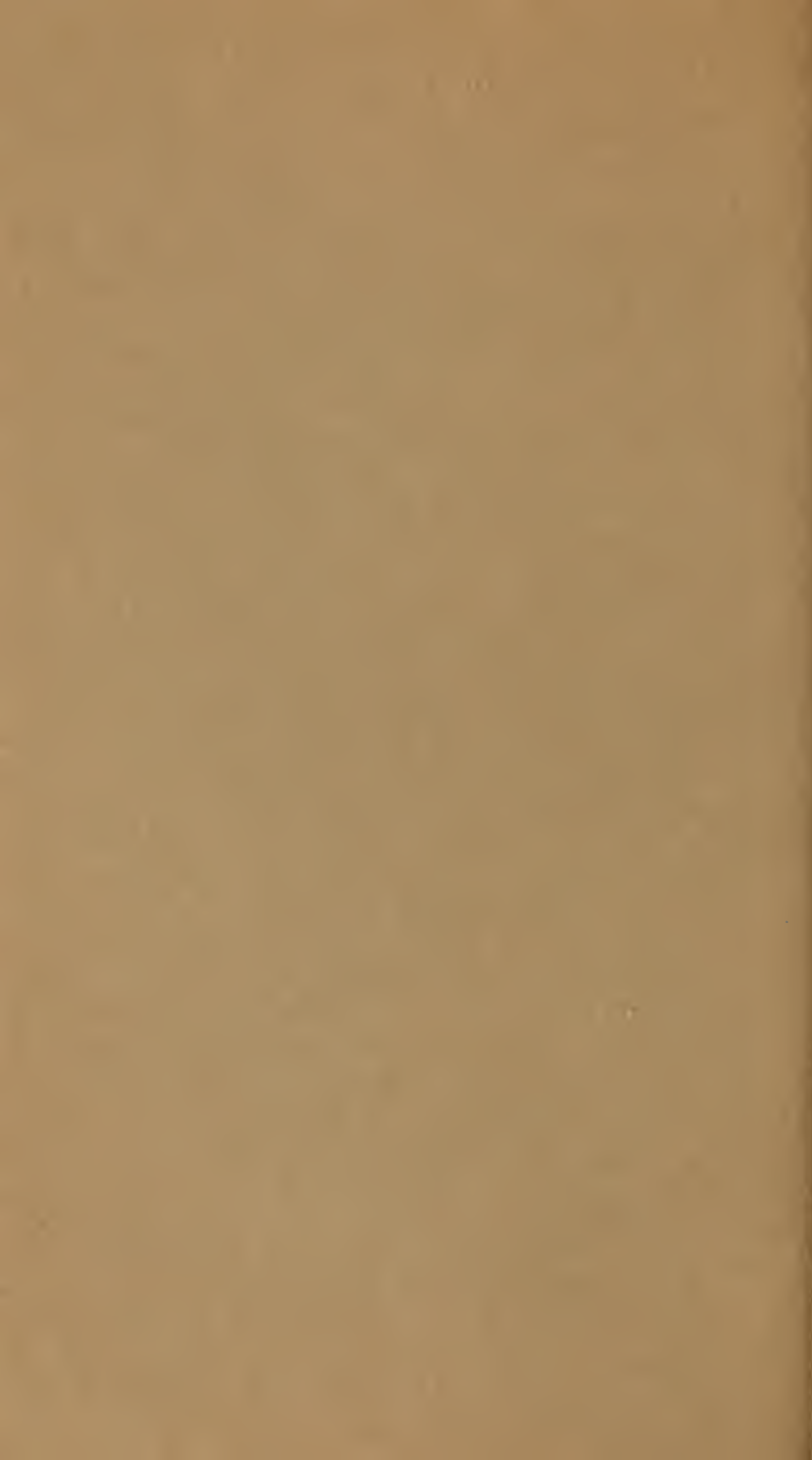

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REPLY BRIEF FOR APPELLANTS.

Introduction.

It is unfortunate that the self-styled "conservative counsel for the Trustee" are so restrictive in their thinking by confinement to the usual and stereotyped situations in bankruptcy that they cannot look beyond the barriers of their experience to see the gradual approach by the courts to a liberal and sensible treatment of claims and counter-claims, to reach an equitable conclusion in such situations.

Absent bankruptcy, there would seem to be nothing in the law which prevents a party indebted to another in a trust capacity from setting off, in his final accounting, an indebtedness of the *cestui* to him. Assuming that a Trustee did so account in full, he could, of course, immediately thereafter, or simultaneously, sue and obtain a judgment against the *cestui* for the amount due. The doctrine of set-off cuts across this needless proceeding. What is there in the law of bankruptcy which prevents the same result as between a so-called fiduciary creditor and a trustee in bankruptcy? In considering this aspect of the appeal, the question of mutuality of the respective claims should be, as counsel for appellee concede [T. Br. 8],[1] divorced from any question of voidable preference. The naked issue is, do the claim of the Trustee for the amount of the special account and the claim of appellants for cash advances constitute mutual debts or credits. Appellee contends that they do not because the claim of the Trustee is based upon the fiduciary's liability and the claim of appellants is a "straight" claim for money due and owing. The Trustee's preoccupation with the idea that his claim is not a "general" claim or indebtedness and is therefore removed from the scope of the doctrine of set-off in bankruptcy, is responsible for the basic error in appellee's position.

---

[1]When appellants' opening brief is hereafter referred to, it will usually be indicated by the bracketed abbreviation [O. Br. ....], and when the brief for the trustee-appellee is referred to, it will be indicated as [T. Br. ....].

It is this misconception which appellants attempted to dissipate in their opening brief [O. Br. 15-29], wherein cases were cited which recognize the "broad significance to be given to the phrase 'mutual credits' and demonstrate that actual or equitable ownership by a bankrupt of the funds or property held by a creditor against which the creditor asserts his counter demand, does not preclude the operation of set-off."

Except as to *Half Moon Fruit and Produce Co. v. Floyd,* 60 F. 2d 799, as to which an erroneous discussion is presented by appellee, no attempt is made to distinguish appellants' authorities and no contention presented to show their inapplicability to appellants' position.

The same is true as to appellants' contentions as to avoidable preferences which appellee terms a straw man argument. As this Court has doubtless already perceived, the straw man was a creature of the Referee who wanted it to be understood that if he was wrong in his conclusions as to the mutuality of the respective claims, the preference theory was a convenient refuge.

ARGUMENT.

I.

Appellee's Point I to the Effect That Because the Jack L. Rau Special Account Was Held by Rau as Trustee for the Bankrupt and That, Therefore, Appellants Have No Right to Set Off a Debt Due From the Bankrupt to Them Is Not Sound and Is Not Supported by the Authorites Relied Upon.

The principal thesis of appellants' opening brief is that the equitable ownership of the fund in the Rau special account or capacity in which it was held in the name of Rau, is not determinative against the right of set-off and does not mean that the respective claims were not mutual within the meaning of Section 68(a) of the Bankruptcy Act. Supporting that proposition, appellants cited cases which recognize the "broad significance" given to the phrase "mutual credits" and holding that "the yardstick for the determination of the right of set-off in bankruptcy is whether each owes the other, and if such reciprocal demand exists, one may be set off against the other no matter whether insolvency is present * * *"; and holding, further, that it is not necessary to justify set-off that the claims be of the same character; "claims of different species may be set off if they are mutual," *i.e.,* if each owes the other. There is no satisfactory answer to this position in appellee's brief.

The Trustee takes issue with the use of the word "owe" or "owed," evidently believing that a fund held in a trust capacity, when the activity of the trust is ended, is not "owed" to the equitable owner.

The dictionary definition of the word "owe" is, "to be under an obligation, to render (something) in return for something received; to be indebted in the sum of; to have an obligation to (someone) on acount of something done or received; to be indebted." That the word "owe" merely implies an indebtedness and that there may be an indebtedness "owing" by a trustee to his *cestui* appears in one place, as will be seen, even if the authorities of appellee [*post,* 8].

Appellee attempts, furthermore, to gain support for his position on the ground that the special account was held by Jack L. Rau as Trustee for the bankrupt, not as agent for appellants and that, therefore, appellants have no right of set-off "of such amount" against a debt owing by the bankrupt to them. In his statement of facts, however, the Trustee concedes that appellants, "acting as attorneys for the bankrupt corporation and on behalf of the bankrupt corporation, opened at the Union Bank and Trust Company of Los Angeles a bank account designated as 'Jack L. Rau, Special Account.'" [T. Br. 2.] The Referee made a finding that it was the appellants' law firm, acting as attorneys for the bankrupt corporation, who opened the special account. [Finding III, Tr. 10-11.] Certainly the appellant firm, Desser, Rau & Hoffman, to whom the funds were delivered, and who created the special account, were liable to account for and pay the balance remaining at the time of bankruptcy. Indeed, the order appealed from orders Desser, Rau & Hoffman, as well as, Jack L. Rau, individually, to pay to the Trustee the sum requested to be deducted as a set-off. [Tr. 20.] Hence there is no point in attempting to limit this review

by the technical name or designation of the account as the "Jack L. Rau, Special Account."

To get down to the substance of the argument, it is believed that the best aid appellants can render to this Court is to analyze the authorities discussed and used by appellee.

In attempting to distinguish *Half Moon Fruit and Produce Co. v. Floyd,* 60 F. 2d 799, appellee asserts that in that case the commission merchant was held by this Court to have the right of set-off of the amount of advances previously made to the bankrupt against the proceeds of the sale of melons consigned to the merchant by the bankrupt and owned by the bankrupt. This right of set-off, appellee indicates to this Court, was predicated upon the fact that the merchant was entitled to an equitable lien on the melons consigned to him by the grower and entitled to a "mutual credit" in the set-off sense for the previous advances. Appellee omits the extremely important fact that *the merchant had forfeited this lien* by making an affidavit for attachment, stating he had no lien. This Court held that such a forfeiture or waiver of lien did not render the transfer of the produce to the merchant unlawful where no avoidable preference was created at the time of the transfer. In the *Half Moon* case this Court discussed two propositions: (1) The court held that the transfer of the bankrupt's property occurred at the time of the delivery of the melons to the merchant, not upon the receipt of the proceeds of sale; that while the lien of the merchant was lost or waived by the attachment, that fact did not change the date of the transfer and render an otherwise lawful transaction

unlawful by treating the transfer as occurring at the time of the receipt of the proceeds of sale within four months before bankruptcy occurred; (2) But as a distinct and self-sufficient ground for sustaining the merchant's position, the Court treated the proceeds of the sale of the bankrupt's melons, on which the merchant had no lien, and the indebtedness for prior advances, as a situation involving mutual debts or credits. At page 802 of the opinion, the Court cites with approval, *Murray v. Riggs,* 15 Johns. (N. Y.) 571, 592, where the court said, "that mutual credit was not confined to pecuniary demands, but extended to all cases where the creditor had goods in his hands of the debtor which could not be got at without an action at law, or a bill in equity." As has been said, as between the instant bankrupt and appellants, the money on deposit could not be "got at" without some legal proceeding. In the *Half Moon* case, the referee's order denying the right of set-off, which was approved by the trial court, was reversed with instructions to allow the merchant's claim in full, less credits for 75 cars of melons, "that is to say, $51,101.53," a substantial sum to remove from the bankrupt estate.

Appellee refers to 4 *Collier on Bankruptcy* [14th Ed.] 726 in support of the assertion that where the liability of one claiming set-off, "arises from a fiduciary duty or is in the nature of a trust, the requisite mutuality of debts or credits does not exist, and such person may not set off a debt owing from the bankrupt to such liability." [T. Br. 5.] In the voluminous footnotes "supporting" the broad generality of the text, are revealing decisions. It is to be particularly noted that the "fiduciary duty" mentioned in these decisions *was violated* by the claimant

seeking to set off or counterclaim. Thus, in *Putnam v. Handy,* 251 Mass. 196, there was a breach of fiduciary duty by a corporate officer; and in *Walker v. Man,* 253 N. Y. Supp. 472, there was a breach of duty by a corporate director; and in *Lytle v. Andrews* [C. C. A. 8], 34 F. 2d 252, money was fraudulently received by a controlling stockholder.

Collier quotes, in the footnotes also, what seems to be the explanatory or reconciling case of *Morris v. Winsor Trust Co.,* 213 N. Y. 27, 106 N. E. 753. There a wrongdoer who had misapplied the subject of the trust was held not to be entitled, either under the Bankruptcy Act or under the rules of equitable set-off, to apply a credit that belonged to him in his own right in cancelling his liability as a fiduciary.

Collier goes on to say in the footnotes at page 727 [Footnote 29]:

> ". . . and where a claimant against a bankrupt's estate is also indebted to the estate upon a debt arising from his possession of property belonging to the bankrupt, his duty to account to the bankruptcy trustee cannot be set off against the bankrupt's debt to him *if his possession was wrongful,* but *if his possession was obtained with the bankrupt's consent, the debts are mutual and subject to set-off."* [Emphasis supplied.]

Citing *Bristol v. Killanna Corp.* [C. C. A. 2], 85 F. 2d 667. It should be noted, parenthetically, that the language speaks of a claimant *"indebted to the estate upon a debt arising from his possession of property belonging to the bankrupt,"* a statement distinctly at variance with appellee's contention that the use of the word "owed" by

appellants, in speaking of a trustee's obligation, is unwarranted and creates a basic misconception.

Among other decisions, Collier, in the footnotes, cites the case of *Levy v. Drew,* 4 Cal. 2d 456, which is one of the cases which makes the right to assert a set-off dependent upon whether or not the creditor's possession of the bankrupt's funds or property was obtained properly or improperly. In *Levy v. Drew,* the court, in quoting from and adopting its own prior opinion in the same case, said at page 460:

> "The rule is consistently applied in the federal court that when a debtor, prior to bankruptcy, voluntarily places in the hands of his creditor assets for the particular purpose of extinguishing a debt, and bankruptcy occurs, the creditor can offset his demand against the claim of the trustee in bankruptcy for a return of the assets to the bankrupt estate."

The court then goes on to say:

> "It is equally well settled that the unauthorized possession of funds of the bankrupt can give the creditor no right to apply them to the payment of his own claim to the prejudice of the rights of other creditors. [Citing federal cases.]
>
> "In the instant case, the money was not voluntarily paid to defendant by the corporation, but was forcibly seized by the levy of an execution, nor was it voluntarily handed over to be applied on the particular debt owed to defendant. When his judgment was vacated defendant's possession of the money became illegal and he should have restored it to his debtor."

In the footnotes, at page 727 of 4 Collier on Bankruptcy, appears, in boldface type, "Exception as to attorney at law holding funds of bankrupt." The author

cites *In the Matter of Redmond and Co.* [D. C. Mass.], 17 F. 2d 501, where the court took note of, but distinguished, among other cases, *Western Tie & Timber Co. v. Brown,* 196 U. S. 502. In the *Redmond* case, an attorney, acting for a client, invested money for the client who had been in control of the bankrupt corporation, in certain corporate stock, receiving the dividends which the attorney, Ginsberg, kept in a separate account. He was held to be entitled, under Section 68(a) of the Bankruptcy Act, to set-off his claim for fees as general counsel for the bankrupt corporation against the claim of the trustees in bankruptcy who had been adjudged to be entitled to the stock and dividends as against Ginsberg's client, who had been so in control of the bankrupt corporation. The court said:

> "But I do not go with the trustees to the extent of agreetng that Ginsberg had no right to set-off his claim for services against the trustee's claim to dividends in his hands. The contention of the trustees relative to the right of set-off is based on a well settled doctrine that a simple debt cannot be set off against a quasi-fiduciary obligation such as Ginsberg owed the bankrupt corporation. [Citing the *Western Tie Co.* case and other authorities.]
>
> "These cases and others cited by the trustees, however, deal with the rights of creditors other than an attorney at law. That an attorney at law has a right to set off his claim for compensation against funds in his hands which belong to his client, has long been recognized in the courts of this state. [Citing cases.]
>
> "The Supreme Court of the United States, in considering the right of set-off under Section 68(a), has pointed out that the object of the provisions of

the section was to permit the statement of account between the bankrupt and the creditor with the view of the application of the doctrine of set-off between mutual debts and credits . . .

"I am inclined to the opinion, in view of *Blake v. Corcoran, supra,* which this court may well adopt as stating the applicable law, that the right of set-off which Ginsberg asserts in these proceedings is one which comes within the established principles of set-off and was properly recognized by the Referee.

"I attach no controlling importance that the dividends were kept in a separate account. His obligation to the corporation would have been the same whether he kept the funds separate or mingled them with his own. In every case where an attorney has money in his hands belonging to his client, he assumes a quasi-fiduciary relationship with reference to the funds."

Appellants strongly rely upon *Western Tie & Timber Co. v. Brown,* 196 U. S. 502. [T. Br. 5.] In that case there had been a long course of dealing between the tie company and Harrison, the bankrupt, in which the tie company's employees bought goods from Harrison, who habitually made a record of such purchases and forwarded it to the tie company which would deduct the amounts of the various employees' indebtednesses to Harrison from pay due to them, and would remit such sums to Harrison in full regardless of how much Harrison might be indebted to the tie company at the time of these remittances. The deductions represented, not amounts owing to Harrison by the tie company, but by the latter's employees individually. Thus, when the tie company determined to hold and keep amounts deducted from payroll, and credit

such amounts to the indebtednes of Harrison to the tie company, *it was attempting to extinguish the liability of other persons* to the bankrupt, and allow, as a credit, the amount thereof against the bankrupt's indebtedness to it. At page 507 of the opinion, the court said:

> "We think the findings establish that Harrison sold the goods, not to the tie company, but to the laborers, and, therefore, the result of the sale was to create an indebtedness for the price alone between Harrison and the employees.
>
> "We think, also, that the facts found establish that the course of dealing between Harrison and the tie company concerning the deductions from the payrolls was that the tie company, when it made the deductions, was under an obligation to remit the money collected from the laborers for account of Harrison, irrespective of any debt which he might owe the company."

It was because of this violation of this established course of business that the court held that the tie company was not entitled to retain the proceeds of the collections from its employees, which were distinct and separate from the account between the tie company and Harrison.

The case of *Arkansas Fuel & Oil Co. v. Leisk,* 133 F. 2d 79 [T. Br. 6], falls into the category of cases which hold that no right of set-off exists if the possession was wrongful. In this case, as the court observed, the appellant Arkansas Fuel & Oil Co. "admits that it *wrongfully* converted 8000 barrels of oil belonging to the bankrupt corporation . . ." (Emphasis supplied.)

The true import of the decision of this Court in *First National Bank of Portland v. Dudley,* 231 F. 2d 396, is

not disclosed by appellee's brief. The crux of that case is found in the fundamental principle of equitable estoppel and the waiver of the bank's ordinary right of set-off, which waiver was implicit in the special creditor-debtor arrangement under which it was sought to save the troubled business of the debtor. During November, 1952, the bankrupt, unable to meet its obligations in regular course, advised the bank of its condition and stated that it had a stock of merchandise which could be sold to advantage over a period of time in liquidation of indebtednesses to creditors. The debtor proposed that if the creditors, including the bank, would refrain from seeking immediate payment in full, the debtor would proceed to liquidate its inventory over a period of 12 months and would pay the bank and other creditors in full by making quarterly payments of 25% commencing January 15, 1953. The bank proposed a modification to the effect that 10% a month should be paid to the creditors. This modification was agreed to by the debtor, and the other creditors were advised of the plan, of the approval thereof by the bank and of the participation of the bank therein. The creditors agreed. The debtor then proceeded to liquidate its inventory and make 10% monthly payments to each creditor for five months. The bank received and accepted the monthly payments with accrued interest on its note originally in the sum of $22,000.00 which was thereby reduced to $11,000.00. All of the proceeds of sale were deposited in the bank.

The court found that:

> "By its approval of the bankrupt's plan, and by participation therein, the bank so dealt with its depositor, the bankrupt, and other creditors, as to waive or be estopped or assert the right of set-off."

Upon fundamental principles of equity jurisprudence, the court held that common honesty, ordinary fairness and good conscience required the application of the doctrine of equitable estoppel. By thus inducing other creditors to go along, and themselves abandon any immediate right of action and remedy they might have had, a distinctly special situation was presented as to which the court wisely went back to first principles, making inapplicable the italicized comment of appellee preceding his inadequate discussion of this decision. [T. Br. 6.]

When, in conclusion of the argument under their Point I counsel for appellee exclaims, "No transfer, merely a transformation! Possibly a chemical reaction induced by the injection of one petition in involuntary bankruptcy," they depart from their "conservatism" and attempt to indulge in a little ill-timed and inept sarcasm which adds nothing to the truly grave issues before this Court.

II.

Appellee's Point II Stating That Appellants' Discussion of the Federal Rules of Civil Procedure Is Inappropriate and Irrelevant, Is Unsupported by Any Pretense of Reasoned Argument.

In Appellants' opening brief it was pointed out that under General Order No. 37, the Federal Rules of Civil Procedure, when not inconsistent with the Bankruptcy Act or other General Orders in Bankruptcy, should be followed in bankruptcy proceedings. [Op. Br. 25.] Appellants show that the "legislative" history of Rule 13 applicable to set-offs, and the decisions thereunder, demonstrated the intended and judicially approved liberal scope of the Rule as covering all manner of counter demands no matter how

different in their legal nature. On the face of it, this directly refutes the "conservative" contention that the fiduciary character of the Trustee's claim against appellants prevents the operation of the doctrine of set-off as against appellants' simple claim at law for a definite amount, concededly owing.

When appellee states that no issue concerning the applicability of Rule 13 was before the Referee or the District Court, he forgets that the identical contention was made below both before the Referee and before the Court, as is shown by the briefs filed below which appellee insisted be made a part of this record and which are on file here for this Court's examination.

It is asserted [T. Br. 8] that no case was cited by appellants relating to Section 68(a) or the case at bar. Neither, it may be observed, did appellants cite a case involving a bankrupt newspaper. As has been said, the six-line conclusion of appellee as to this aspect of the appeal does not impair the relevance of appellants' opening discussion of the effect of Rule 13. [O. Br. 25.]

III.

Appellee's Point III to the Effect That There Was No Transfer From the Bankrupt to Appellants and That, if There Had Been, It Would Constitute Avoidable Preference, Is Untenable.

Under this point appellee contends that there was no transfer of funds from the bankrupt to appellants and that, therefore, there can be no preference. If this be so, how did it happen that the funds deposited in the special account by the appellant firm were found in the possession and control of appellants in the Jack L. Rau special ac-

count at the time bankruptcy occurred? Such a statement, of course, is wholly unrealistic because possession and the right and power of disbursement rested in appellants. Jack L. Rau, appellants' designated partner, was required to and did sign the checks drawn on the account which accomplished the transfer to the payees thereof of a corresponding legal claim to the funds on deposit. The transfer to the receiver of the amount on deposit, less the sum claimed by appellants was accomplished, indeed had to be accomplished, by a legal document—a check drawn by Rau on the account. Compliance with the order appealed from would require a "transfer" of funds by a similar check. To say, under such circumstances, that there was no transfer by the bankrupt to appellants is to ignore the facts.

What appellee doubtless means is that there was no transfer of full ownership in the funds by the bankrupt to appellants. But appellants have shown that actual ownership of property of a debtor in possession of a creditor does not operate to defeat the assertion of a set-off or counterclaim.

Appellee, assuming, arguendo, that there was a transfer, contends [T. Br. 7-10] that the mere proximity of the date of the transfer of the funds and the commencement of the proceedings in bankruptcy results in an avoidable preference. Appellee, however, does not indicate why the language of Section 60(a) of the Bankruptcy Act, defining preference as a transfer of property of the debtor to or for the benefit of a creditor for or on account of an antecedent date (neither of which elements is here present), does not control. The "necessary result" of a transaction as creating an avoidable preference, sometimes

loosely expressed by the courts, has reference to the presence of particular circumstances constituting the full equivalent of an actual transfer to or for the benefit of a creditor, for or on account of an antecedent date. If the Congress intended so to broaden the definition, language was available for that purpose. As was shown in appellants' opening brief, the essential element of a preference "is something which diminishes the estate." [*National Bank of Newport v. National Herkimer County Bank,* 225 U. S. 178, 184; O.Br. 37.] In the instant case, the "estate" was not diminished, because, at the time of bankruptcy, the bankrupt had, in its asset column, the demand against appellants for the existing balance of the special account in the total sum of $16,163.15, and at the same time, in its liability column, was a debt of $3,217.68 owing to appellants. The net balance, or net asset represented by these concomitant items was $12,945.17, which was remitted to the receiver. The deduction of the sum of $3,217.68, while diminishing the assets in possession, also diminished the total of liabilities in exactly that amount. The net estate remained the same.

As the court said in *New York County National Bank v. Massey, trustee,* 192 U. S. 138:

> "It is true that it (the deposit) creates a debt, which, as the creditor may set it off under Section 68, amounts to permitting a creditor of that class to obtain more from the bankrupt's estate than creditors who are in the same situation and do not hold any debts of the bankrupt subject to set-off. But this does not, in our opinion, operate to enlarge the scope of the statute defining preference so as to prevent set-off in cases coming within the terms of Section 68(a). If this argument were to prevail, it would, in cases of

> insolvency, defeat the right of set-off recognized and enforced in the law, as every creditor of the bankrupt holding a claim against the estate subject to reduction to the full amount of a debt due the bankrupt receives a preference in the fact that, to the extent of the set-off, he is paid in full." [O. Br. 37.]

Appellee concludes his argument by stating that both appellants and appellee agree that there was no transfer of funds by the bankrupt to appellants. There is not and never has been any such agreement. Mistakenly, appellee regards the use of the word "transfer" as implying the conveyance of title. In their opening brief, appellants cited, among other authorities, cases involving the transfer, or delivery, of melons, the proceeds of the sale of which were to be forwarded to the grower who owned both the produce and the proceeds of sale [O. Br. 11]; the transfer of cloth to be made into clothes which, when made, were to be delivered to the bankrupt [O. Br. 20]; the transfer of parcels to a delivery service for delivery and collection, both parcels and produce belonging to the bankrupt. [O. Br. 20.] In each case set-off was allowed. In the instant case the bankrupt, prior to bankruptcy, transferred funds to appellants who selected Rau as their medium of holding, transferring and distributing same by checks signed by Rau. Here there was a transfer not only of the physical funds but also the power of disposition. The debts to be paid to creditors out of the special account could not have been paid without an actual transfer of funds to appellants.

Conclusion.

It is again urged that the order of the District Court be reversed with directors to allow appellants to reimburse themselves from the special account the sum of $3,217.68, the amount concededly due for actual out-of-pocket expenses.

Respectfully submitted,

Desser & Hoffman,

David R. Nisall,

Jack L. Rau,

Attorneys for Appellants.